

Chapter 1

Strategic financial objectives

Chapter learning objectives:

Lead	Component	Indicative syllabus content
A.1 Advise on strategic financial objectives.	(a) Analyse different types of organisations and their objectives. (b) Advise on financial objectives. (c) Advise on non-financial objectives.	<ul style="list-style-type: none"> • Profit and not-for-profit organisations • Quoted and unquoted companies • Private and public sector organisations • Value for money, maximising shareholder wealth Earnings growth, dividend growth • Impact of underlying economic conditions and business variables on financial objectives • Enhancing the value of other non-financial capitals (human capital, intellectual capital and social and relationship capital) • United Nations Sustainability Development Goals

1. Mission and the objectives of different entities

Mission: The fundamental objective(s) of an entity, expressed in general terms.

Mission statement: A published statement, apparently of the entity's fundamental objective(s). This may or may not summarise the true mission of the entity.

- The mission and objectives of an entity depend upon:
 - the type of entity, and
 - the requirements of the various stakeholders of the entity.
- The main objective of a profit-making entity is to maximise the wealth of shareholders.
- The main aim of not-for-profit entities is to benefit specific groups of people. However, as they do need funds to provide services, their secondary objective is to raise the maximum funds and use them efficiently.

Definitions of different types of entity

- **Profit-making entities:** many companies operate with a view to earning profit. Their main objective is thus to satisfy their shareholders by making a profit.
- **Not-for-profit entities:** the main objective of these entities is not to earn profit. These entities have primary objectives that are usually non-financial in nature. Most public sector entities are not-for-profit entities.
- **Incorporated entities:** an incorporated entity is one that is legally separate from its owners. There is a greater potential for conflict of stakeholder objectives due to the likelihood of there being several owners.
- **Unincorporated entities:** an unincorporated entity is one that is not considered separate from its owner/s, and thus the owners bear the risks associated with the entity's business. Sole traders and partnerships are usually unincorporated entities.
- **Quoted entities:** an incorporated entity that is listed on the stock exchange. The shareholders of the company can buy and sell its shares. A quoted company is subject to increased scrutiny and so should set appropriate objectives relating to the environment and staff.
- **Unquoted entities:** the entity's shares are not quoted on the stock exchange.
- **Private sector entity:** an entity owned by private investors.
- **Public sector entity:** an entity that is owned by the government.
- **Charitable entity (charity):** a not-for-profit entity that focuses on philanthropic goals and social well-being, e.g. activities that serve the public interest.
- **An association/union:** a group of individuals who agree on a common purpose as their goal, e.g. trade associations and professional associations (like CIMA).

2. Stakeholder conflict

As an entity will have various stakeholders with different objectives, the entity needs to consider all of the stakeholders' views when setting objectives, even though the shareholders' views have the highest priority. This could lead to an entity having **many objectives that conflict with each other**.

Agency theory: a hypothesis that attempts to explain elements of organisational behaviour through an understanding of the relationships between principals (such as shareholders) and agents (such as company managers and accountants). A conflict may exist between the actions undertaken by agents in furtherance of their own self-interest and those required to promote the interests of the principals. (*CIMA official terminology*)

Agency theory is an example of conflicts between objectives. Managers are agents of the shareholders and conflicts may arise between the interests of the shareholders and the managers.

3. Profit-making entities

Objectives

The main objective of a profit-making entity is to **maximise shareholder wealth**. However, due to having other key stakeholders, the entity will have additional objectives.

A profit-making entity will have both financial and non-financial objectives.

A company's objectives can be grouped into:

- **Primary objectives** (the ultimate long-term objective(s), often financial)
- **Secondary objectives** (lower priority, a stepping stone to achieving the primary objective(s))

Financial objectives

When establishing objectives, certain factors will need to be considered:

- Shareholder attitudes
- Finance providers' requirements
- Suppliers' credit terms
- Exposure to risk
- Government restrictions and incentives

To achieve financial objectives, the management will set financial targets such as an increase in profitability by a certain percentage or setting a debt:equity ratio.

These financial targets will set the company's direction and assist in measuring its performance.

Non-financial objectives

Factors to consider when determining non-financial objectives:

- Employee expectations and demands
- Managers' personal objectives
- Suppliers' requirements and relationships with them
- Government's interest in the entity
- Local community
- Customers' interests

Non-financial business objectives can be useful as part of a **balanced scorecard** (covered in E3).

4. Not-for-profit entities

- The **primary objective** of a not-for-profit entity is to fulfil the purpose it was set up for, which is usually non-financial.
- Its **secondary objective** is to raise and use funds efficiently to maximise benefit, so it needs to ensure sound financial management if it is to conduct its affairs smoothly.
- A not-for-profit entity will also have both **financial** and **non-financial objectives**.
- However, setting financial objectives in a public entity is complex as the objectives cannot be defined in terms of return achieved on the capital employed because the benefits are intangible and the operations of such entities are regulated by the government.
- Not-for-profit entities are often assessed according to the **value-for-money (VFM)** that they generate.

Value for money: performance of an activity in such a way as to simultaneously achieve economy, efficiency and effectiveness. (*CIMA official terminology*)

Value for money audit: an investigation into whether proper arrangements have been made for securing economy, efficiency and effectiveness in the use of resources. (*CIMA official terminology*)

Assessing Value For Money (VFM)

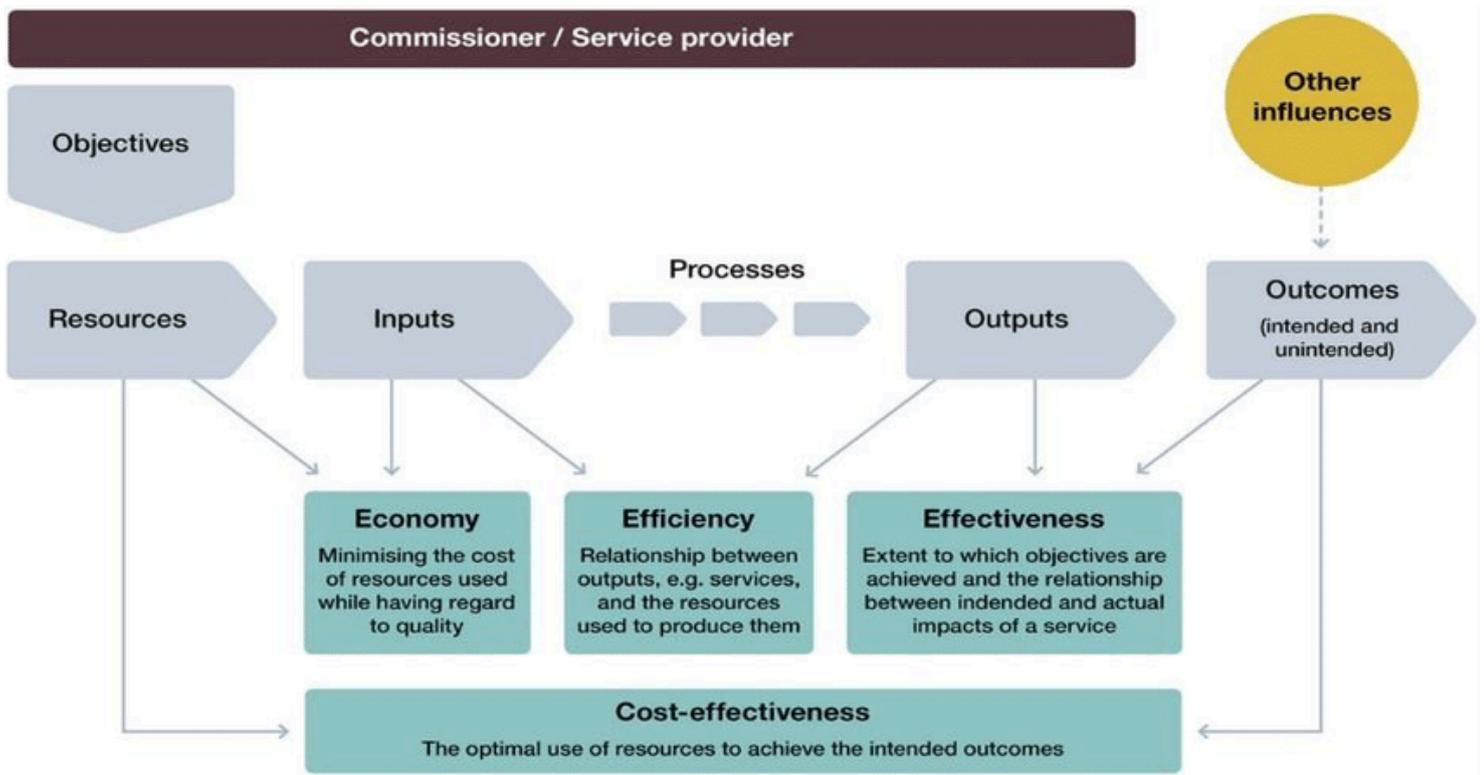


Other than the three integral components of VFM, economy, efficiency and effectiveness, another component is sometimes used, **equity**.

Equity determines whether the services have reached all of the people that they were intended to reach.

A *value-for-money audit* gives an opinion on the value for money achieved, i.e. the outcomes reached with the resources available.

Overview of VFM (according to the UK National Audit Office)



5. International operations

An organisation may decide to expand its business to other countries. This will have both strategic and financial consequences for the organisation.

Strategic consequences

- An entity may find it beneficial to operate in a foreign market where competition is less intense than in the domestic market.
- Cost savings could be achieved by shifting production facilities to a country with cheaper raw materials and labour. Also, governments may offer further incentives to foreign investors.
- Moving to foreign markets is likely to increase the customer base and improve relationships with foreign customers.
- Economies of scale could be achieved via international expansion.
- Exposure to multiple economies could minimise or increase economic and political risks.

Financial consequences

- A positive NPV is one major reason for international investment.
- Foreign exchange risk will arise, as exchange rates fluctuate year on year.

- Foreign investments are generally risky, and this will likely be reflected in the entity's cost of capital.

6. Evaluating financial performance

Stakeholders will generally assess the performance of an organisation by using ratios. If the company's financial performance is declining, shareholders may sell their shares and lenders may change their assessment of the company's creditworthiness.

7. Profitability ratios

Profit figures in the statement of profit or loss

$$\text{GROSS PROFIT MARGIN} = \frac{\text{gross profit}}{\text{revenue}} \times 100$$

$$\text{OPERATING PROFIT MARGIN} = \frac{\text{operating profit}}{\text{revenue}} \times 100$$

$$\text{NET PROFIT MARGIN} = \frac{\text{net profit}}{\text{revenue}} \times 100$$

GROSS PROFIT = sales – cost of sales

OPERATING PROFIT = sales – profit before interest and tax

NET PROFIT = profit after deduction of interest and tax

EBIDTA

Many companies use the EBITDA measure of performance, which is earnings before interest, tax depreciation and amortisation.

Recently, controversies have arisen around EDITDA:

- It has been suggested that it is sometimes used to publicise a higher measure of earnings than profit from operations.
- Users of EBIDTA need to understand what is included in the measure, as depreciation and amortisation are accounting adjustments set up by the management and do not represent cash flow.

Return on capital employed (ROCE)

$$\text{RETURN ON CAPITAL EMPLOYED (ROCE)} = \frac{\text{operating profit}}{\text{capital employed}} \times 100$$

- Capital employed = shareholder funds + long-term debt OR total assets less current liabilities
- Measures management efficiency in generating profits from the available resources
- Expressed as a percentage

Further analysis of ROCE:

$$\text{RETURN ON CAPITAL EMPLOYED (ROCE)} = \text{PROFIT MARGIN} \times \text{ASSET TURNOVER}$$

$$\frac{\text{operating profit}}{\text{capital employed}} \times 100 = \frac{\text{operating profit}}{\text{revenue}} \times 100 \times \frac{\text{revenue}}{\text{capital employed}}$$

- A higher ROCE results from increased sales from the capital and also from increased operating profit margin. The opposite also applies.
- A comparison of the profitability ratio with previous years and other similar businesses can be used to analyse the company's performance.

Return on Equity (ROE)

$$\text{RETURN ON EQUITY (ROE)} = \frac{\text{net profit}}{\text{equity}} \times 100$$

- Shows how well the company has performed in relation to shareholder equity
- Expressed as a percentage

Asset turnover

$$\text{ASSET TURNOVER} = \frac{\text{revenue}}{\text{capital employed}} \times 100$$

Indicates how much revenue has been earned in relation to \$1 of investment

Interpretation of profitability ratios

- Just remember this – higher levels are desirable.
- Different industries will have different reference values.

8. Debt and gearing ratios

Gearing: the relationship between an entity's borrowings, which includes both prior charge capital and long-term debt, and its shareholders' funds. (CIMA official terminology)

Capital gearing

There are two ways to calculate gearing (the question will usually indicate which to use but if not, the 2nd is more common):

$$\text{DEBT EQUITY RATIO} = \frac{\text{debt}}{\text{equity}} \times 100 (>100\%)$$

OR

$$= \frac{\text{debt}}{\text{debt} + \text{equity}} \times 100 (50\%)$$

- Debt = redeemable preference shares, bank borrowings and bonds
- Equity = irredeemable preference shares and ordinary shares
- Market value of equity = number of shares x share price
- Market value should be used, but if it is not available, use book value, which is ordinary share capital + reserves

Debt ratio

$$\text{DEBT RATIO} = \frac{\text{total long-term debt}}{\text{total assets}}$$

- Usually used by creditors and represents the availability of assets in relation to total debt

Interest cover

$$\text{INTEREST COVER} = \frac{\text{profit before interest and tax (PBIT)}}{\text{interest payable}}$$

- Indicates whether the company is generating enough profit to cover the interest charge
- EBITDA can be used instead of PBIT

9. Investor ratios

Earnings per share

$$\text{EARNINGS PER SHARE (EPS)} = \frac{\text{earnings (profit after interest and tax)}}{\text{number of shares}}$$

- Remember that EPS is a historical figure and can be manipulated by amending accounting policies, etc.

P/E ratio

$$\text{P/E RATIO} = \frac{\text{current share price}}{\text{EPS}}$$

- Measures growth by comparing market value to current earnings.
- A higher P/E ratio indicates a greater expectation of future earnings growth.

Earnings yield

$$\text{EARNINGS YIELD} = \frac{\text{EPS}}{\text{current share price}} = \frac{1}{\text{P/E ratio}}$$

- Represents the future earning power of the entity

Dividend payout rate

$$\text{DIVIDEND PAYOUT RATE} = \frac{\text{dividend per share}}{\text{EPS}} = \frac{\text{Total dividend}}{\text{Total earnings}}$$

- Measures the cash effect of paying out a dividend

Dividend yield

$$\text{DIVIDEND YIELD} = \frac{\text{dividend per share}}{\text{current share price}}$$

- Shows the dividend paid in relation to the market price

Dividend cover

$$\text{DIVIDEND COVER} = \frac{\text{EPS}}{\text{dividend per share}}$$

10. Liquidity ratios

$$\text{CURRENT RATIO} = \frac{\text{current assets}}{\text{current liabilities}}$$

- Determines the entity's ability to pay off its current liabilities

$$\text{QUICK RATIO} = \frac{\text{current assets} - \text{inventory}}{\text{current liabilities}}$$

- Measures the liquid assets against the current assets of an entity

$$\text{INVENTORY DAYS PERIOD} = \frac{\text{inventory}}{\text{cost of sales}} \times 365$$

- The average number of days that inventory is held in stock before being sold

$$\text{RECEIVABLE DAYS} = \frac{\text{trade receivables}}{\text{credit sales}} \times 365$$

- The average number of days it takes an entity to collect outstanding amounts from its debtors

$$\text{PAYABLE DAYS} = \frac{\text{trade payables}}{\text{credit purchases}} \times 365$$

- The average number of days it takes a company to pay its creditors

11. Sensitivity analysis

Changes in economic and business variables will affect financial forecasts and possibly impact the entity's ability to achieve its financial objectives.

Businesses need to forecast these changes so that they recognise and respond to changes in a timely manner.

Economic variables:

- **Increased interest rates** will lead to reduced spending by customers, a decrease in the value of assets, foreign funds being invested in the country's banks (which could then be loaned to the entities), reduction in inflation and a rise in exchange rates.
- **Fluctuations in inflation** can weaken a country's competitive position, cause planning and production difficulties for businesses, redistribute wealth and income, destabilise markets and distort consumer behaviour.

Parity theory

Interest rate parity

$$\text{Interest rate parity: } F_0 = S_0 \times \frac{(1+r_{var})}{(1+r_{base})}$$

S = spot rate of exchange

F = forward rate of exchange

r_{var} = interest rate of variable currency

r_{base} = interest rate of base currency

Expectations theory

$$\text{Expectations theory: } S_1 = S_2 \times \frac{(1+r_{var})}{(1+r_{base})}$$

S_0 = spot rate of exchange

S_1 = expected rate of exchange in one year

r_{var} = interest rate of variable currency

r_{base} = interest rate of base currency

Business variables:

These factors include changes in margins and volumes, such as changes in sales volumes and profit margins, that can affect the profitability ratios.

12. Limitations of published accounts for ratio analysis

- Ratios calculated using the published accounts of an entity will only be based on historical records. Future prospects cannot be assessed fully.
- The published accounts tend to focus on financial aspects while ignoring non-financial issues, thus reporting only a limited part of the performance of the entity.
- The statement of profit and loss is based on the accruals concept, so the cash position of the entity remains unclear. For this, the cash flow statement would need to be analysed.

13. Chapter summary

